The Reality of Recapture Tax

Some home buyers, builders, Realtors and mortgage lenders who want to use the Indiana Housing Finance Authority's low interest rate loans or our mortgage credit certificate program are concerned about the federal "recapture tax". This simple explanation may alleviate those needless worries and help more people who could benefit from our First Home and First Home/Plus Program and Mortgage Credit Certificate Program.

EXPLAINING ITS HISTORY

A federal law commonly known as "recapture tax" applies to borrowers who buy their homes using Mortgage Revenue Bonds (MRBs) like those issued by the Indiana Housing Finance Authority.

Recapture tax requires some mortgagors to repay the government a portion of their gain upon the sale of the home if they financed their home with an MRB loan. The Internal Revenue Service (IRS) administers this provision. If any recapture tax is due, the mortgagor pays it to the IRS after selling the home. At the loan closing, IHFA provides a "Notice of Maximum Recapture" letter showing the maximum recapture tax which could be due, if any.

REMOVING THE MYSTERY

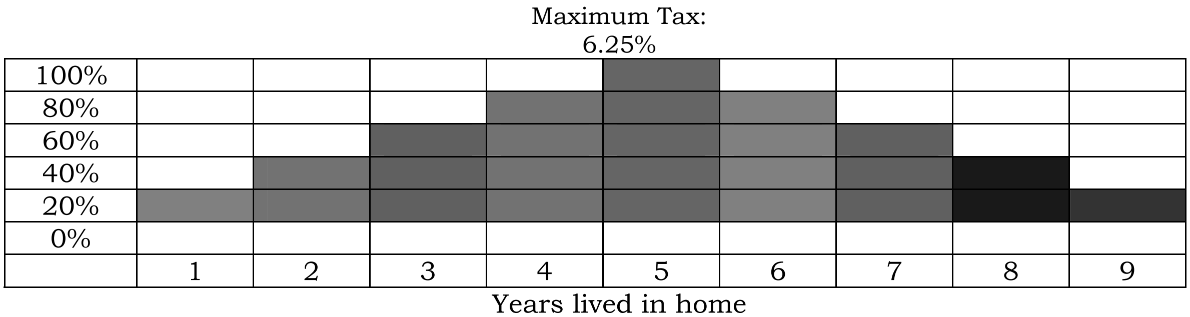
In reality, most borrowers will not have to pay any recapture tax. For others, the amount will be minimal. In any case, the tax will never exceed one-half of the gain on the sale of the home, or 6.25% of the original mortgage amount, whichever is less.

This may sound complicated, but in many cases, no tax is due. For example:

- If your household income does not rise significantly over the life of the loan (generally more than 5 percent per year), there is no recapture.
- If you sell your home anytime after nine years, there is no recapture.
- If you sell your home within nine years but there is no gain, there is no recapture.

In others words, to owe any recapture tax at all, you must sell your home within nine years, earn significantly more income than when you bought the home, *and* gain from the sale. All three of these criteria must be met.

The basis of recapture is this: Mortgagors will never pay more than 6.25 percent of the original loan amount and usually will pay less, if they pay at all. Recapture taxes are figured on a scale based on the number of years the homebuyer has lived in the house, with the fifth year being the worst time to sell (see chart on reverse side)..



The maximum recapture tax due is only 6.25 percent in year five of homeownership.

But that's not the end of the story. The tax guidelines are structured to help mortgagors even if they do have to pay.

- The 5 percent increase in income that makes a mortgagor a candidate for recapture is figured from the maximum income limit for the MRB or MCC program at the time of purchase. For example, Fred earned $40,000 per year when he purchased his home. At the time, the maximum income limit was $50,000. The 5 percent increase would be figured from $50,000, not $40,000. Fred would actually have to receive in excess of a 5 percent increase in salary each year to be considered for recapture.
- Recapture tax may not exceed 50 percent of the gain the mortgagor realizes upon the sale of the home. Even if Fred sold his home in year five, his income increased significantly, and he made $2,000 off the sale, the maximum he could owe is $1,000. And the gain is calculated *after* items such as Realtor, legal and closing fees are subtracted.
- If the mortgagor's income exceeds the maximum income limit, but not by more than $5,000, only a percentage of the tax must be paid.

When the program serves those it's intended for, recapture is seldom a threat. For most people, the financial benefits of homeownership—deductions for mortgage interest and taxes as well as the program's lower interest rates, down payment assistance or federal tax credit—far outweigh the risks of recapture.

ADDITIONAL ANSWERS

Will recapture eliminate a borrower's gain from the sale of the home?

Fortunately, no. The recapture tax can never exceed 50% of the gain.

How does the IRS track the amount of recapture tax due?

IHFA is required to report to the IRS the name, address, and Social Security numbers of all recipients of MRB and MCC loans. The borrower is required to file IRS form 8828 with his/her federal income tax return for the tax year in which the house is sold or transferred.

Is recapture tax due if the borrower dies within the nine-year period?

No. A death transfer is not a sale or transfer for the purposes of recapture.

What if the home is destroyed as a result of fire, flood or other natural disaster?

If the home is destroyed and the borrower rebuilds on the same site within two years after the year in which the insurance proceeds are received, no recapture tax is due at that time.

For more information, consult your tax professional.